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Earnings per share; Accounting Research Bulletin, no. 49

American Institute of Certified Public Accountants. Committee on Accounting Procedure

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Accounting Research BULLETINS

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Issued by the
Committee on Accounting Procedure
American Institute of
Certified Public Accountants
270 Madison Avenue, New York 16, N. Y.

April, 1958

No. 49

Earnings per Share

1. Statistical presentations of periodic net income (or loss) in terms of earnings per share¹ are commonly used in prospectuses, proxy material, and annual reports to shareholders, and in the compilation of business earnings statistics for the press, statistical services, and other publications. This bulletin deals with a number of problems arising in the computation and presentation of such statistics.

2. The committee has previously considered certain aspects of this matter² and now reaffirms its earlier conclusions that:

- (a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;
- (b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and
- (c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.

3. Not only does the use of a single figure for earnings per share involve the same limitations of usefulness as does a single figure

¹As used herein, the term *earnings per share* connotes either earnings or losses per share.

²Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (1953), Chapter 8, par. 14. Also see Chapter 2(b), par. 4.

for net earnings, but also, in many circumstances, the computation of earnings per share involves unique problems. While it is desirable to achieve as much uniformity as is feasible, clear explanation and disclosure of methods used are especially important in this area of financial reporting.

4. The committee suggests the following general guides to be used in computing and presenting earnings per share:

- (a) Where used without qualification, the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding
- (b) Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the current equivalent of the number of shares then outstanding.
- (c) *In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.*

SINGLE-YEAR COMPUTATIONS

5. In the computation of earnings per share for a single year, minor increases or decreases in the number of shares outstanding during the year may be disregarded, and it is appropriate to base the computation on the number of shares outstanding at the end of the year. In the case of a substantial increase or decrease in the number of shares resulting from the issuance or reacquisition of stock for cash or other property during the year, it is generally appropriate to base the computation of earnings per share on a weighted average of the number of shares outstanding during the year. Where there has been little or no opportunity to utilize the proceeds from the issuance of such shares, as would most clearly be the case when the shares were issued shortly before the end of the year, such

shares may be disregarded in the computation. When an increase in the number of shares outstanding results from a stock dividend or a stock split, or a reduction in the number of shares outstanding results from a reverse split, without proceeds or disbursements, the computation should be based on the number of shares outstanding at the end of the year. For purposes of determining the number of shares outstanding, reacquired shares should be excluded.

6. If there has been a stock split^a or a reverse split after the balance-sheet date but before the issuance of the financial report, it is desirable to base the computation of earnings per share on the new number of shares, since the reader's primary interest is presumed to be in the present stock position. Similar considerations may apply to stock dividends,^a although a relatively small stock dividend may properly be disregarded. In these cases of changes after the balance-sheet date, it is preferable to choose the more useful and informative basis of computation rather than to present two simultaneous and possibly confusing computations on different bases. When computations of earnings per share reflect changes in the number of shares after the balance-sheet date, it is important that this fact be clearly disclosed since there may be a presumption that earnings per share are based on the number of shares shown on the balance sheet. It is equally important that significant changes in the number of shares after the balance-sheet date be disclosed when such changes are not reflected in the computation of earnings per share.

7. Where there are shares outstanding senior to the common stock or other residual security, the claims of such securities on net income should be deducted from net income or added to net loss before computing per-share figures, since the term *earnings per share* is ordinarily used to designate the amount applicable to each share of common stock or other residual security outstanding. In arriving at net income applicable to common stock for purposes of the per-share computations, provision should be made for cumulative preferred dividends for the year, whether or not earned. In the case of a net loss, the amount of the loss should be increased by any cumulative preferred stock dividends for the year. Where such

^a See Accounting Research Bulletin No. 43, Chapter 7(b).

dividends are cumulative only if earned, no adjustment of this nature is required except to the extent of income available therefor. In all cases the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of common stock should be disclosed.

8. The following special considerations relate to convertible securities:

- (a) When debt capital, preferred stock, or other security has been converted into common stock during the year, earnings per share should ordinarily be based on a weighted average of the number of shares outstanding during the year. When the weighted average is used in such cases, adjustments for the year in respect of interest or other related factors are not made.
- (b) When capitalizations consist essentially of two classes of common stock, one of which is convertible into the other and is limited in its dividend rights until conversion takes place as, for example, when certain levels of earnings are achieved, two earnings-per-share figures, one assuming conversion, are ordinarily necessary for full disclosure of the situation.

COMPARATIVE STATISTICS

9. Presentations of earnings-per-share data for a period of several years should be governed basically by the criteria for single year presentations, but may involve a number of special considerations in view of changes in conditions during the period, and the purpose for which the data are to be used. It should be recognized that any tabulation of earnings per share for a period of years may have little bearing on the present position, and may fail to give any indication of present expectations. Variations in the capital structure may have substantial effects on earnings per share. The usefulness of such statistics depends in large measure on collateral historical information and disclosure of methods of computation used. The committee's recommendations which follow are intended as guides to general uniformity but not as substitutes for explanations and

disclosures or as cures for the inherent defects in statistical presentations of earnings per share.

10. When computations of earnings per share for a period of years, such as are submitted in annual reports and in prospectuses, include periods in which there have been stock splits or reverse splits, the earnings for periods prior to the dates of the splits should be divided by the current equivalent of the number of shares outstanding in the respective prior periods in order to arrive at earnings per share in terms of the present stock position. Similar treatment should be accorded to stock dividends; however, it is permissible not to extend such treatment to small recurrent stock dividends, although in a prospectus or when such dividends in the aggregate become material, consideration should be given to recognizing the cumulative effect thereof. On the other hand, where, during the period of years for which data are given, there have been issuances or reacquisitions of stock for cash or other property, or, issuances in connection with conversions of debt capital, preferred stock, or other security, the computations of earnings per share for the years prior to such changes are not affected; it follows that earnings per share for these years should be based on the number of shares outstanding in the various years. When both situations have occurred, the effect of each should be reflected in accordance with the foregoing recommendations.

11. When equity securities are being publicly offered:

- (a) If there have been significant conversions of debt capital, preferred stock, or other security during the period of years for which data are given, it is appropriate to present supplementary calculations revising past figures to reflect subsequent conversions, on a pro forma basis.
- (b) If the securities being offered, or their proceeds, are to be used to retire outstanding securities in circumstances which assure such retirement, it may be useful to present, in addition to otherwise appropriate calculations, supplementary computations to show pro forma earnings per share for at least the most recent year as if such substitution of securities had been made. When this is done, the basis of the supplementary computations should be clearly disclosed. Where, however, the securities being offered, or their proceeds, are

to be used, not to retire existing securities, but for such purposes as expansion of the business, earnings per share should be computed without adjustment for any increase in the number of shares anticipated as a result of such offering.

12. Where there has been a pooling of interests⁴ during the period of years for which data are given, in connection with which the number of shares outstanding or the capital structure in other respects has been changed, the method used in computing earnings per share for those years prior to the pooling of interests should be based on the new capital structure. When there is to be a pooling of interests in connection with which the number of shares outstanding or the capital structure in other respects will be changed, earnings per share for any period for which income statements of the constituent companies are presented in combined form should be computed on a basis consistent with the exchange ratio to be used in the pooling of interests. In either case earnings per share should, in all other respects, be computed in conformity with the principles set forth in the foregoing paragraphs.

EARNINGS COVERAGE OF SENIOR SECURITIES

13. Where periodic net income is related to outstanding shares of senior securities, such as preferred stock, the committee believes that, under most circumstances, the term *earnings per share* is not properly applicable in view of the limited dividend rights of such senior securities. In such cases it may be helpful to show the number of times or the extent to which the requirements of senior dividends have been earned, but such information should not be designated as earnings per share.

MISCELLANEOUS

14. It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share—

⁴ See Accounting Research Bulletin No. 48, *Business Combinations* (1957).

for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.

DIVIDENDS PER SHARE

15. Although this bulletin deals primarily with earnings per share, certain considerations may apply comparably to dividends per share. In general, dividends per share constitute historical facts and should be so reported. However, in certain cases, such as a stock split as mentioned in paragraph 10, a presentation of dividends per share in terms of the current equivalent of the number of shares outstanding at the time of the dividend is necessary so that dividends per share and earnings per share will be stated on the same basis. When dividends per share are stated on any other than the historical basis, it is generally desirable that such statement be supplemental to the historical record, and its basis and significance should be fully explained.

The statement entitled "Earnings per Share" was unanimously adopted by the twenty-one members of the committee.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department,

and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

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